

Choices for Japanese Fiscal Policy

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Working Paper No. 207

Translated by David Harvey

**Working Paper Series
Center on Japanese Economy and Business
Columbia Business School
February 2003**

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Discussions of fiscal policy in Japan often founder on disagreements over how to read recent history. Has counter-cyclical policy had any impact on Japan's economic performance, particularly in the 1990s, and is there scope for using it to stimulate the economy now? How pressing is the need to reduce the government budget deficit? Does the size of the government debt make any additional fiscal stimulus risky? In fact, fiscal policy has been effective, both prior to and during the 1990s. Moreover, Japan's savings-investment balance makes continued use of fiscal policy both possible and desirable.

For the last ten years, debate in Japan has revolved around monetary policy and whether or not it has been both prudent and feasible to ease monetary policy further. At the same time, there has been little consensus on what fiscal policy should be, which has caused actual policy in the last decade or so to swing wildly between opposing goals of 'economic stimulus' and 'fiscal revitalisation' or austerity.

For example, in the early Nineties, economic stimulus was emphasized. Several packages of public works spending and tax reductions were implemented in an effort to jump-start the economy. In 1997, however, following two years of relatively good growth in

1995 and 1996, fiscal policy took a sharp turn toward 'fiscal revitalisation' with an increase in the consumption tax and reductions in public works. Then, as the economy began to slow, the debate about which fiscal policy was more appropriate became more intense. The government's response to renewed economic weakness was very slow, as many in the ruling party argued that the long-term health of the government finances was more important than dealing with short-term economic fluctuations. A large 16.7 trillion yen stimulus package was finally introduced in 1998, when it had become apparent that there was no hope of an autonomous recovery. Expanded budgets aimed at stimulating the economy were also implemented in fiscal 1999 and 2000¹. Such measures eventually led to at least a temporary bottoming out of the economy in 1999 although private demand was very slow to respond, suggesting that the elements for a self-sustained recovery were not firmly in place.

Part of the reason for the large swings in fiscal stance was an error in the government's economic forecast. There was also confusion about the effectiveness of fiscal policy and the importance of the fiscal deficit (and the way politicians exploited this confusion for their own gain). In addition, the shifts reflected voters' widespread dissatisfaction with the wasteful, 'pork-barrel' character of the government's spending programs.

To give one concrete example, we consider the problem of the relationship between the

¹ Translator's Note. The prospects improved by mid-2000, and it appeared then that the economy was finally coming out of the doldrums.

'economic recovery' and 'fiscal revitalization' that was the subject of Parliamentary debate in early 2000. Then-Prime Minister Obuchi maintained that he "should not be pursuing two hares at the same time" to justify his single-minded pursuit of economic recovery. Yukio Hatoyama, the head of the opposition Democratic Party of Japan (Minshuto), retorted that such an argument would apply only when "the two hares are running in the opposite directions." It was his view that 'fiscal revitalisation' (and an improvement in the allocation of funds) would help bring about economic recovery, so that two hares ought to be chased at the same time.

The US Administration also supported a generous fiscal policy to stimulate the Japanese economy, though journalists and academics - and some prominent credit agencies - voiced doubt about the wisdom of such a policy. Opponents of an expansive fiscal policy often cite the failure of successive stimulus packages - totaling some 100 trillion yen in the 1990s - to achieve any lasting improvement in Japanese economic growth² and contend that what Japan needs is

² Translator's Note. Economic Stimulus Measures since 1992 (trillion yen)

Date	Headline Figure	Real Water	Supplementary Budget (Addition to the general account)
31 March 1992	-	-	-
28 August 1992	10.7	7.8	2.5
13 April 1993	13.2	7.4	2.4
16 September 1993	6.0	2.0	6.4
8 February 1994	15.3	9.6	2.2
14 April 1995	-	-	2.8
27 June 1995	-	-	-
20 September 1995	14.2	9.1	6.0
18 November 1997	-	-	-
24 April 1998	16.7	12.3	5.1
16 November 1998	17.0 (approx)	14.1	8.5

structural adjustments and fiscal discipline. They claim the focus on economic stimulus merely delays the necessary structural adjustment and postpones the inevitable by allowing unworthy players to survive longer.

This essay will attempt to make a critical assessment of the debate and to put Japanese fiscal policy into some sort of perspective. In doing so, we look at specific arguments by focusing on the following five headings which are examined in turn. (Note, however that point 5 is such a major issue in itself that it has been discussed in a separate paper written by the author³.)

- (1) Has the effectiveness of fiscal policy been permanently eroded in recent years compared with earlier periods?
- (2) Does the neutrality theorem -which states rational people react to government fiscal policy in a way that offsets the policy thrust-apply in Japan?
- (3) Is the Japanese fiscal position so precarious that priority should be give to reducing the deficit?

11 November 1999	17.0 (approx)	6.8	8.1
19 December 2000	11.0 (approx)	4.7	5.8
6 April 2001	-	-	-
26 October 2001	5.8	0	3.0

Source: Mizuho Research Institute

³ K. Inoue, *Nani ga Tadashii Keizai Seisaku ka* [Choices for Japanese fiscal policy] (Nihon Keizai Shimbun, Inc) June 2000 (Chapter 4)

(4) Can there be any means to improve the way public expenditures are allocated?

(5) Does an expansive fiscal policy delay necessary structural adjustments?

1. THE EFFECTIVENESS OF FISCAL POLICY

Discussions of fiscal policy tend to be overly dominated by theoretical or ideological preferences.

It is wrong, however, to assume that there is a single correct theory that can be applied to every country at every point in time. This is because the effects of fiscal policy depend upon the reactions of private entities, in particular (a) whether households and companies increase their expenditures; and (b) how financial markets react to the increased need of the government to fund the deficit. Japan's experience in the last decade offers conflicting evidence, all of which needs to be assessed together in order to reach valid conclusions.

1992-94: A period little influenced by policies

As a starting point, we look at the early 1990s and particularly the period from about 1992 to 1994 when the economy stagnated as a reaction to the excesses of the bubble period. Faced with an economic slump, the government switched its fiscal priority from reducing the deficit - a goal that it had pursued fairly consistently through the 1980s - to stimulating the economy.

Supplementary budgets introduced for this purpose amounted to nearly 8 trillion yen in the three

years from 1992 to 1994. The response of the economy was quite limited, however, and growth in real GDP was only 0.4%, 0.4%, and 1.1 % respectively in fiscal years 1992, 1993 and 1994⁴.

Before this time, fiscal policy in Japan had been considered both an effective and predictable tool for stimulating the economy. Thus, sluggish growth in this period led to considerable dismay both among policy-makers and private sector economists and gave rise to a debate about whether the government spending "multiplier" had become much smaller. The debate found an echo on the micro level, as well as, for example, producers of basic materials complained that the demand for their products was not rising at a rate consistent with the increase in public works, as had been the case in the past. One leading steel manufacturer noted that demand for steel products had traditionally risen by 300,000 tons for every one trillion yen incremental increase in public works expenditure. However, in the early 1990s that one trillion yen incremental increase led only to a 100,000 ton increase in demand for steel.

With the help of hindsight, however, given the experience since 1995 (see below), it appears that the pessimism about the effectiveness of fiscal policy at this time was excessive. It is true that the multiplier effect in this period was very small and the economic stagnation

⁴ Translator's Note. Growth in Real GDP

Fiscal Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Real GDP (yoy change) (%)	+2.5	+0.4	+0.4	+1.1	+2.5	+3.4	+0.2	-0.8	+1.9	+1.7	-1.8

Source: Economic and Social Research Institutes, Cabinet Office (<http://www.esri.cao.go.jp/>) (December 2002)

protracted. But one can hardly expect a stable value for the multiplier in changing circumstances.

The effect of fiscal measures on total demand reflects the willingness of households and companies to increase their own expenditures in response to the initial gain in income caused by increased government outlays. In the early 1990s, there was a huge overhang of excess capacity in the form of capital equipment, housing, and consumer durables that reflected over-investment during the bubble years. While this is a normal feature of a business cycle, the scale of overbuilding in the 1980s was unusually large, and made it inevitable that there would be a longer-than-usual period of adjustment.

At the same time, there was an unusually large decline in asset prices - specifically, for land and shares - following the run-up of the 1980s. This caused an unusually large deterioration in corporate and household balance sheets, which added to the constraint on expenditure.

Moreover, because of the rise in the yen, there was additional pressure on Japanese companies to reduce costs and reallocate resources such as factories and labor to maintain competitiveness against other East Asian economies.

It is clear that strong forces were at work during this period, which diminished the effectiveness of any fiscal stimulus. Because the multiplier was small at that time, though, does

not mean any reduction in the effectiveness of such policies is permanent⁵. Indeed, a study by the Economic Planning Agency (EPA)⁶ found that the fiscal spending multiplier in the 1990s as a whole was only marginally less than in earlier periods.

It is not surprising that when the multiplier is small on a macro basis, demand does not increase in proportion to the level of the increase in public works. Another study by the EPA found no reduction, in volume terms, in the use of materials nor in the production-inducing coefficient (the degree to which overall production is raised) induced by increased public-works construction (1994 White Paper). In other words, the ripple effect on other industries was unchanged on a real basis.

It is also important to consider how to measure incremental fiscal stimuli. The Japanese government always announces a "headline" figure, in describing each of its policy packages that is much larger than the actual amount of new budgetary outlays in the plan. Indeed, even adding up the "real water" in supplementary budgets can greatly exaggerate the actual fiscal contribution. This is because the government invariably started with initial budgets that - although ostensibly drawn up with "the precarious state of the economy" in mind - were in fact restrictive, usually

⁵ More specifically: the 1999 White Paper reported findings that, while households' marginal propensity to consume out of new income fell slightly during the 1990s, and the marginal propensity for leakage into imports was unchanged – which together imply some decline in the government spending multiplier – the degree of "crowding out" and the tendency to push up the yen exchange rate (the Mundell-Fleming effect) were both smaller than in the 1980s. This means that the impact of changes in fiscal spending, while it may have been smaller in the short term, would have been more lasting in the 1990s environment than it had been earlier.

⁶ The Economic Planning Agency has since been subsumed by The Cabinet Office

projecting a decline in public works spending compared with the previous year's total after inclusion of the supplementary budget(s). These initial budgets were described as "stimulative" but this was only in comparison with the initial budget of the previous year⁷.

As an example, the central government's actual public works outlays for fiscal 1994 (executed with the money provided by that year's budget) were in fact, smaller than those for fiscal 1993--- by 600 billion yen. This incidentally illustrates one of the dangers of relying on fiscal expenditures to shore up the economy: Once this approach has been used, it requires bigger and bigger doses of spending to have any impact. The metaphor thus becomes one of using narcotics - rather than the traditional "pump-priming" image in which the initial stimulus works by prompting a quick and self-sustaining reaction from private spending. Further, one must

⁷ Translator's Note. Japanese Budgets

Fiscal Year	Initial Budget (trillion yen)	Increase in Initial Budget over previous year's Initial Budget (%)	Final Budget (including Supplementary Budgets) (trillion yen)	Increase in Initial Budget over previous year's Final Budget (%)	Increase in Final Budget over previous year's Final Budget (%)
1991	70.3	+6.2	70.6	+0.9	+1.3
1992	72.2	+2.7	75.3	+2.3	+6.7
1993	72.4	+0.2	72.4	-3.9	-3.9
1994	73.1	+1.0	79.0	+1.0	+9.1
1995	71.0	-2.9	78.0	-10.1	-1.3
1996	75.1	+5.8	77.8	-3.7	-0.3
1997	77.4	+3.0	82.3	-0.5	+5.8
1998	77.7	+0.4	82.3	-5.6	0.0
1999	81.9	+5.4	89.0	-0.5	+8.1
2000	85.0	+3.8	83.7	-4.5	-6.0
2001	82.6	-2.7	86.4	-1.3	+3.2
2002	81.2	-1.7	-	-6.0	-

Source: Ministry of Finance

measure the effect of fiscal stimulus by comparison with what would have happened in its absence - not by comparison to the pace of growth that might have been desired. Indeed, the economy would have experienced a deep recession in these years if it had not been for the support from fiscal policy. The direct contribution to overall demand growth - that is, before considering any multiplier effect - of public investment amounted to 2.0 percentage points in fiscal years 1992-94, exceeding the total cumulative growth of GDP of 1.5%. (Public investment⁸ corresponds to the total year on year increase of public works investment by both central and local governments executed during this period after the supplementary budgets.) This of course means the economy would surely have posted negative growth had it not been for the fiscal stimulus.

1995 to 1997: A review

The experiences in 1995-97, in contrast with the early 1990s, demonstrated that fiscal policy CAN have a sizable impact on the economy, in both positive and negative directions. Fiscal policy remained stimulative in both fiscal 1995 and 1996. On top of the "special" (i.e., temporary) income tax reduction that was introduced in 1994 and continued through 1996, which

⁸ Translator's Note. In Japanese, '*koteki kotei shisan honkeisei*'. The term is also referred to as public fixed capital formation.

totaled 9.5 trillion yen, a permanent tax reduction (of 3.5 trillion yen each year) was introduced in September 1995 along with a large injection of public works spending.

Aggregate demand was thus sustained. Moreover, the post-bubble stock adjustments in the private sector had run their course, and growth of private non-residential investment resumed.

Real private non-residential investment, which had declined for three consecutive years between fiscal 1992 and 1994, registered an increase of 3.6% in fiscal 1995, and then accelerated to 8.5% in fiscal 1996⁹. Reflecting this vigorous investment, year on year growth of real GDP rose to 2.5 and 3.4%, respectively, in fiscal 1995 and 1996¹⁰. These were high growth rates by international standards for this period. Meanwhile, the contribution of public investment to changes in real GDP tapered off to 0.6% for fiscal 95 and -0.2% in fiscal 1996¹¹.

⁹Translator's Note.

Fiscal Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Real Private Non-residential investment (yoy change) (%)	+1.0	-9.2	-11.1	-4.5	+3.6	+8.5	+8.9	-5.1	-0.3	+9.3	-4.7

Source: Economic and Social Research Institutes, Cabinet Office (<http://www.esri.cao.go.jp/>) (December 2002)

¹⁰Refer Note 4

¹¹ Translator's Note

Fiscal Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Contribution to Real GDP Growth made by Public Investment (%)	+0.3	+1.1	+0.9	-0.1	+0.6	-0.2	-0.5	+0.1	-0.1	-0.6	-0.5

Source: Economic and Social Research Institutes, Cabinet Office (<http://www.esri.cao.go.jp/>) (December 2002)

Economic process does include autonomous, cyclical mechanism, but cyclical swings should be understood to be very large if unmitigated by policy, particularly when confidence is eroded¹². It is more natural to interpret the expansion of the economy in 1995-96 as due to fiscal policy regaining its former impact. So, while the favorable impact of fiscal policy was apparent to many who lived through this period, sceptics could still argue that the economic cycles always produce an end to stock adjustments. They might further say that this period simply coincided with an autonomous cyclical upturn that had very little to do with fiscal policy.

This argument is hard to refute since we cannot experiment with the economy. It would be easy to use econometric models to say that the trough would have come much later but for the fiscal stimuli. But those models only show the average of past behaviours and there is no knowing how close to the average economic agents would have behaved in the absence of fiscal policy.

However, it is certain that the economy would have shown negative growth in the

¹² There is usually a tendency for the economy to become stronger during times of strength and weaker during times of weakness. This is due to the short-term cycle of production → income → expenditure, which is effective in only one direction at time being either expansionary or contractionary. Nevertheless, apart from this trend for one direction, there is a mechanism concerning capital investment, housing and durable consumer goods whereby the stock levels are adjusted to desired levels based on the long term demand from companies and households taking account of income prospects. In addition, concerning retail consumption, changes in consumption levels are kept even and there is pressure to maintain average levels. The economic cycle uses the strength of these mechanisms to counteract the one directional short term cycle mentioned above. When it is exceeded we can say there has been an autonomous turnaround (peaking out or a bottoming out). From this perspective, in the early 1990s we can see the breakdown in the 'myth of an ever rising market' and asset price deflation led to a reduction in desirable levels of investment in fixed capital. This was also a period during which consumers adjusted their attitudes towards consumption. Consequently, the above-mentioned mechanism for an autonomous turnaround became even more difficult. As a result of the pessimism concerning the actual prospect of low growth, it has been difficult to complete stock reductions.

previous period --notwithstanding the fact that the multiplier had become small. As stock adjustments in housing, consumer durables and fixed capital is a process in which economic agents try to balance the stock of these items with the present incomes and future demands, it is safe to say that adjustments would have been more prolonged if the economy did not grow, albeit very meagerly.

In any case, circumstantial evidence for the importance of fiscal policy is clearly to be found in the period 1997-98, when no fiscal help was forthcoming despite the economic downturn. Every economic force worked in a contractionary direction; there was no source of autonomous upward momentum at all. There can be little doubt that the economic downturn that started in the middle of 1997¹³, and which eventually turned into a severe recession, was the result of an abrupt turn in the government's fiscal stance.

The impact of a switch away from a stimulative fiscal policy was amply demonstrated in the spring of 1997 when the government placed priority on "fiscal restructuring," or discipline, assuming that the economy had entered a sustainable recovery path. The consumption tax was raised from 3 to 5 percent, the "special" temporary income tax reduction was discontinued, and public works investment was curtailed.

¹³ Admittedly, this is also the period when Japan's economy suffered from the negative impact on exports from the economic crisis in emerging Asian economies. That episode made the withdrawal of fiscal stimulus even more untimely than it would otherwise have been. But it cannot be blamed for the economy's downturn, since net exports contributed positively to total demand in both fiscal 1997 and 1998.

Following the change in policy-and arguably in response to that changed policy-- there was a sudden, swift decline in the economy against a backdrop of widespread concern about the viability of the financial system as Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities all collapsed in November 1997.

The effects were immediate. Household income fell, as did personal consumption. And since one person's consumption is somebody else's income, the multiplier effect assured that this led to a downward spiral of aggregate consumption and income levels. Many people had expected that "rational" consumers would reduce their savings ratio to offset their consumption, as called for by the neutrality theorem (see below), but this did not happen.

Real private non-residential investment also fell. As of the first half of 1997, the corporate sector was largely unaware that there was excess capacity. In 1997, the investment cycle was still at a fairly young stage and there was not a large accumulation of capital stock. But after showing a year on year rise of 8.9% in fiscal 1997, such investment plummeted to minus 5.1% in fiscal 1998¹⁴. The implication is clear: investment in fixed capital would not have entered such a severe adjustment but for the sudden decline in demand.

The government absolutely failed to predict this downturn. The Economic White Paper for 1997 was very upbeat on the economy, saying "the transition from the policy-supported

¹⁴Refer Note 9

recovery to an autonomous recovery centered on private demand is more or less complete." The Bank of Japan was considerably more cautious, but it too thought that a downturn could be avoided, saying: "The pace of recovery might decelerate for the time being, but there are good chances that the upward momentum itself would be maintained."¹⁵ One of the basic factors behind these forecasts was the "immaturity" of the recovery. In other words, the failure to maintain a stimulative policy had a major, unfortunate impact on the Japanese economy in 1997.

1998: The exceptionally large supplementary budget

Real GDP recorded quarterly declines in 1997 and 1998¹⁶ as the recession became one of the most severe in the post-war period. By February 1999, industrial production had dropped 12.5% from its peak. Meanwhile, unemployment set a post-war high and exceeded 4% by April 1998. However, the government initially did little, letting the economy run its course, partly out of a false sense of optimism and partly because of its commitment to reduce the budget deficit. (The Law to Reform Government Financial Structure¹⁷, which pledged the central and local

¹⁵ Bank of Japan Monthly, June 1997

¹⁶ Translator's Note

Calendar Year	Q1/97	Q2/97	Q3/97	Q4/97	Q1/98	Q2/98	Q3/98	Q4/98	Q1/99	Q2/99	Q3/99
Growth in Real GDP (qoq) (%)	+1.6	-3.1	+1.7	+0.4	-1.1	-0.5	+0.1	+0.2	-1.0	+2.1	+0.9

Source: Economic and Social Research Institutes, Cabinet Office (<http://www.esri.cao.go.jp/>) (December 2002)

¹⁷ This law pledged the central and local governments together to post a combined deficit no more than 3% of GDP by fiscal 2003.

governments together to post a combined deficit no more than 3% of GDP by fiscal 2003 was adopted in 1997.)

It was only December 1997, at the time of the submission of the budget for fiscal 1998, that the government first changed its stance slightly with the offer of 2 trillion yen in "special" tax relief. By this time, however, the economy was clearly in trouble; a small dose of fiscal stimulus could hardly reverse it. Then, in April 1998, the government was forced to change course once more and proposed an unprecedented 16.7 trillion yen stimulus package. This package was not only large in scale; it also went well beyond the traditional public-works-spending approach to include income tax reduction and tax incentives for housing investment.

Why did the government fail to understand the gravity of the economic situation? There is some doubt as to whether the error in the government's economic outlook at this time was just an "honest mistake," meaning that it did what it could given its own flawed estimates of the economy. Instead, it appears that government forecasts around this time were made to support the government's predetermined fiscal stance, and were not based on careful analysis of economic data.

It took quite a while after the shift in fiscal stance before the sentiment clearly improved.

In terms of real GDP, however, the effects were to appear very quickly. The second quarter of calendar 1999 already showed a turn around to a substantial positive number, and growth in the third quarter was also positive, albeit much smaller¹⁸.

The composition of real GDP growth in this period suggests clearly that this bottoming-out was brought about by policy, and not the result of an autonomous recovery. Fixed business investment, which is a major determinant of economic activity, in fact kept declining, reflecting the surge in the sense that there was excess capacity. It is no exaggeration to state that the growth at the time was entirely led by public works that fostered personal consumption as well as housing investment, (which benefited from tax incentives and other policy measures). In addition, comprehensive measures to deal with problems in the financial system also helped¹⁹. These measures succeeded in calming down the panicky mood amongst companies and also facilitated the smooth flow of credit to small- and medium-sized companies.

In short, there were several periods in the 1990s when fiscal policy was actively used with varying degrees of efficacy. In the early 1990s, fiscal policy did not have a strong impact. However, this was an exception rather than the rule. From the mid-1990s onward, economic

¹⁸ Translator's Note. The second quarter of calendar 1999 showed real GDP growth of 2.1% (qoq, saar), and the following quarter had growth of 0.9%. Source: Economic and Social Research Institute, Cabinet Office.

¹⁹ Translator's Note. Households' reaction to the unprecedented news of major financial institutions' bankruptcy – most particularly that of Yamaichi securities – had been a major contributor to the downturn, and their reassurance by these measures was a precondition for ending it.

cycles were the result of shifts in fiscal stance: positive in 1995-96; negative in 1997; and positive again in 1999.

These experiences suggest that fiscal policy can be a powerful counter-cyclical influence; it is only in exceptional circumstances that it is not. The history of this period suggests that reducing budget deficits and stimulating the economy are not compatible at least in the short term. Putting aside the issue of how government money is allocated - which, as discussed below, can be greatly improved- the two "hares" referred to in the Parliamentary debate between Obuchi and Hatoyama are running in opposite directions, forcing policymakers to choose between the two.

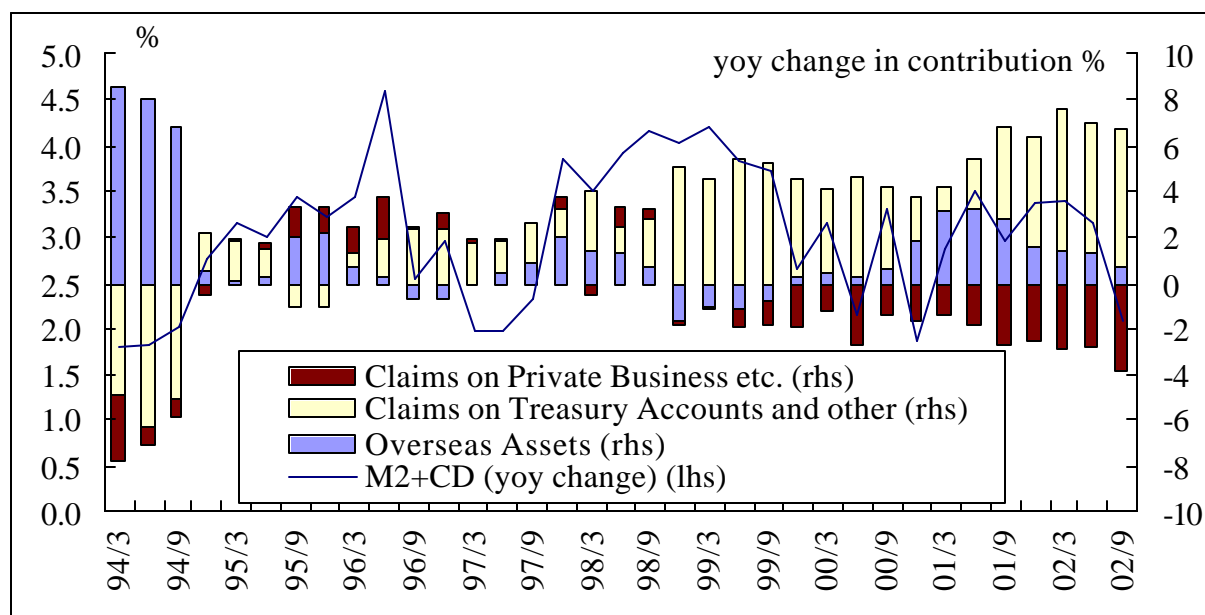
Creation of money supply through fiscal spending

Fiscal policy was an important path for money creation throughout almost the entire decade of the 1990s. Following the turmoil in the credit-markets in late 1997, as banks became cut back their lending, money supply would have shrunk but for the fiscal deficit which the banks financed.

A fiscal deficit tends to directly increase money supply because the government is giving out more money to the private sector than it is taking in. (Sometimes, the resultant deficit is financed by the private, non-bank, sector through the purchase of government bonds. While

fiscal spending disperses funds and creates money, if the bonds issued to finance the spending are purchased by non-bank players, the purchases by such players will be matched by a corresponding reduction in cash holdings. However, during this period, despite an easy monetary policy, there was not much demand for money, nor willingness on the part of banks to lend, leading the banks to buy up the newly issued government bonds instead. When government fiscal deficit leads to money creation, it is called "monetization" of the deficit, and it is common to assume the central bank's underwriting of government bonds as the primary route for this. Although the Bank of Japan never engaged itself in such an operation, "monetization" in the broad sense took place thanks to the commercial banks' purchases of government bonds. This can be seen by examining the "credit counterparts" of money supply. This approach looks at the asset side and the net worth of the combined balance-sheet of the banking sector. Bank deposits, as the main component of money supply, appear on the liability side of such balance-sheet. The following chart shows the "supply routes" of money by this approach. It is clear from the chart that commercial banks' credit extension to the public sector contributed to money creation in the 1990s, in fact, since the beginning of 1998, it has been the most important source of money creation. In other words, despite a credit crunch, fiscal policy had a double economic impact by creating money as well as adding to the effective demand as banks supplied credit to the public sector.

Chart. Changes in Money Stock (M2+CDs) and Credit in Japan



Source: Bank of Japan (<<http://www.boj.or.jp>>) (December 2002)

Many economists presuppose that money supply can be increased if the central bank so wishes.

The basic framework of analysis of the IS-LM ('Investment - Savings' - 'Liquidity - Money')

model is a case in point. But such a framework is quite inadequate in understanding Japan's

situation in late 1990s and early 2000s.

2. THEORETICAL OPPOSITION TO THE EFFECTS OF FISCAL POLICY

The Rational Expectations Hypothesis and The Neutrality Theorem

Theoretical opposition to the effectiveness of fiscal policy has been put forward, most notably by several prominent American economists. One argument against the effectiveness of fiscal policy is the "neutrality theorem" (also known as the "rational expectations" hypothesis). In a nutshell, this theory argues that if people are rational in their forecast of the future, the government's effort to prop up the economy by increasing public expenditures or cutting taxes will only lead consumers to expect tax increases at some future date. This in turn induces them to curtail their present consumption, offsetting the impact of larger public expenditures. According to this theory, a temporary tax reduction would also be ineffective. This implies that the effect of fiscal policy is neutral to the course of the economy. Robert Lucas, one of the very early proponents of this theory, received the Nobel Prize for economics in 1995. Some empirical research results on Japan as well as a brief survey of literature are presented in the Economic White Paper for 1998. This hypothesis is by no means firmly established, as the empirical results presented to support the theory are open to different interpretations. It is easy to conceive of a household to which this theory does not apply: If a household is so poor as to consume all its earnings - under a liquidity constraint - it cannot save for the future tax increase and this hypothesis would clearly not apply. However, it is widely accepted that current consumption for moderately well-off households

depends not just on current income but also on future earning prospects - that is, permanent income. There is a broad consensus, at least, that the effects of policy actions depend on how they impact people's outlook and expectations.

Those opposed to active use of fiscal policy in Japan often refer to the huge size of the deficit rather than cite the neutrality or rational expectations theory. In the debate leading to the tax reduction in 1998, however, some insisted that the reduction had to be "permanent" to have any impact on consumption. Clearly, the debate was influenced by these concepts. Indeed, in the parliamentary debate of February 2000, Mr. Hatoyama of the opposition Democratic Party referred to the "neutral theorem" in his attack on the Government's stance of putting priority on economic recovery.

As already noted, the effects of fiscal policy were relatively weak in the first half of the 1990s. This, taken alone, might be interpreted to mean that Japanese people had become more "rational" in their expectations as budget deficits grew. However, economic cycles since then, namely a strong recovery in 1995-96, a sharp turnaround in 1997 and the bottoming-out in 1999 all originated from the strong impact of fiscal policy. It is clear that the "neutrality theorem" does not always apply since movements in the government sector in Japan were not completely offset by private sector moves in the opposite direction. Also, it is more plausible to interpret the earlier caution in 1992-94 as the result of severe stock adjustment pressures and the deterioration in

balance sheets rather than as the result of people becoming more "rational".

Very "irrational" consumer behavior---experiences at the time of the rise in consumption tax rate.

The raising of the consumption tax rate from 3% to 5% in April 1997 serves as a good test case of the theory of the rational consumer. The temporary tax relief, which had been effective for a three-year period up to then, was also discontinued. It is noteworthy that both measures had been announced three years beforehand. If consumers were "rational" as defined by the theory, they would have raised their savings ratio in the three-year period when taxes were temporarily low, and would have lowered their savings after the awaited tax increase became effective. However, the exact opposite occurred. Instead, personal consumption declined after April 1997 and the savings ratio shot up.

Of course, the "rational expectations hypothesis" was not tested in its pure form. As in all tests of hypotheses in social science, other things were not equal. The unexpected rise in the savings ratio must have reflected other factors, too. In late 1997, awareness was growing that national pension schemes were nearly bankrupt. Moreover, financial system turmoil shook public confidence following the collapse of several large and well-known financial institutions such as Hokkaido Takushoku Bank. Furthermore, unemployment was also on the rise.

Still, given that the large-scale fiscal stimulus measures adopted in fiscal 1998 succeeded in bringing about a bottoming-out, it is hard to assert that people's expectations were formed "rationally." It is particularly hard to claim that personal consumption in Japan was much influenced by the public's expectations of future tax increases and any reduction in personal spending would offset the effects of fiscal policy. Such expectations affect consumption far less than the level of current income and/or the fear of losing one's job.

The government's Economic White Paper for 1998 concluded that: "With the deepening of the recognition about the budget deficit, people are getting more sensitive to its widening...In this situation, it cannot be ruled out that an expansion of the budget deficit will no doubt, by giving rise to the fear regarding their future (tax) burdens, lead to households becoming cautious when increasing their expenditures." The White Paper further said, in a footnote, "circumstances have been changing into one where neutrality theorem would apply more." The 1999 White Paper cited this footnote and reiterated the same message.

It is a bit incongruous that the same 1999 White Paper stressed the process through which fiscal policy had led to the bottoming-out of the economy as "the result of audacious and quick actions." If the neutrality theorem had applied, as the Paper implied elsewhere, fiscal policy would not have been effective no matter how "audacious and quick" the measures might have been. This inconsistency probably reflects the view of some elements within government

circles that wished to put a lid on the use of fiscal policy. Be the cause as it may, evaluation of policy actions has to be consistent. The summing-up at present juncture then ought to be:

Notwithstanding the fact that the public is increasingly more aware and concerned about future taxes and pension schemes, the effect of fiscal policy in stimulating the economy is still very large.

3. HOW PRECARIOUS IS JAPAN'S FISCAL POSITION?

How money is spent is much more important than the revenue gap

Many analysts, both inside and outside of Japan, believe Japanese government finances are already close to collapse, and cite the ratio of either the current deficit or cumulative government debt to GDP as proof. By either measure, Japan's fiscal situation is indeed the worst among industrialized countries. Some go further and assert that the true picture is even worse, considering the rapid aging of the population and its impact on state pension schemes. These analysts say priority should be given to restoring discipline to government finances even if the short-term impact on the economy is negative. For example, American economist Paul Krugman asserts there is no room to use fiscal policy and proposes that Japan should adopt inflation

targeting²⁰.

In these arguments, the state of government finances is usually measured by the gap between revenue and spending, with little discussion of the overall level and allocation of expenditures. The 1997 Law to Reform the Structure of Government Finances reflects such thinking. However, the truly relevant issue concerning government finances is whether the level and direction of spending are appropriate, given the current needs of the country.

To single out only the fiscal deficit (i.e., the gap between revenue and expenditures) and to compare it with the GDP, and to further argue that it is a burden on future generations, can be both misleading and incorrect. A given level of deficit spending can be either "good" or "bad" depending on how the money is spent. (The tax system, which is an important issue in discussion of the budget problems, is beyond the scope of this paper.)

The magnitude of the deficit

First, consider just the magnitude of the deficit and government debt. To use the often-cited figures of comparison with the GDP, estimates in the Economic White Paper 2000 were for the combined deficit of central and local governments for fiscal 1999 to reach 9.2% of GDP, while

²⁰ P. Krugman, "*Japan's Trap*" (May 1998), (<http://web.mit.edu/krugman/www/japtrap.html>) and "Further Notes on Japan's Liquidity Trap" (June 1998) (<http://web.mit.edu/krugman/www/liquid.html>)

the gross debt at the end of fiscal 2000 was expected to reach 129.3% of GDP²¹.

Since GDP measures the total value-added in a given period, it might legitimately be compared with the size of government economic activities. But there is no economic reason why GDP should be compared with the fiscal deficit²². Since the fiscal deficit represents the excess of investment over savings by the government, it is far more important to see it in the context of the investment-savings balance of the nation as a whole²³.

The flow-of-funds accounts are designed to do this. On a flow basis, the "flow-of funds" accounts show that the excess of investment over saving by the government sector was indeed very large in 1998, but the excess of savings over investment by the corporate and household sectors was even larger, so that Japan as a whole still had excess savings amounting to 16 trillion yen. This total excess savings corresponds to Japan's current account surplus in that year - which

²¹ Translator's Note. For reference more recent data compiled by the OECD shows the following trend:

Calendar Year	1997	1998	1999	2000	2001	2002
Combined deficit of central and local governments/ GDP (%)	5.3	6.7	7.8	7.3	7.0	7.3
Gross Debt/GDP (%)	92.0	103. 0	115. 3	123. 2	132. 0	141. 5

Source: Japanese Ministry of Finance citing OECD – Economic Outlook (Issue No. 70, December 2001)

²² However, if we look at the framework for future spending, it is important to consider whether or not the accumulated debt (= outstanding government debt) will be contained below a certain level. Therefore, this concerns the relationship between growth in revenues and the growth in GDP (the elasticity of tax revenues for GDP) as well as interest rate levels.

²³ It should be said that – in contrast with the situation in other countries – nearly 50% of Japan's outstanding government debt is actually held by the public sector itself: this includes the large holdings of the social security fund, the government's Trust Fund Bureau, the Bank of Japan, and the postal savings and postal insurance systems. Even so, however, the level of net debt has been rising rapidly and is no longer extremely low by international standards. And, perhaps most importantly, the size of current government deficits assures that this net debt will keep growing at a very fast pace.

by definition represents the accumulation of net foreign assets by the country as a whole.

Next we look at the flow-of-funds accounts on a stock level basis. The combined net debt of central and local governments (financial assets less financial liabilities) amounted to 422 trillion yen at end-March 1999²⁴. At the same time, the combined net debt of the private non-financial corporate sector stood at 483 trillion yen²⁵ while the household sector held net financial assets of 944 trillion yen²⁶. Reflecting the balance of these positions (together with some minor omissions), Japan as a whole showed a net overseas assets of 136 trillion yen²⁷.

More importantly, these figures show that central and local government borrowing is far from exhausting the domestic savings pool. And that is exactly why long-term interest rates are

²⁴ Translators Note. Revised data as of December 2002

End of Fiscal Year	1997	1998	1999	2000	2001
Net Debt of Central and Local Governments (Financial Assets less Financial Liabilities) (Trillion yen)	358	422	461	493	521

Source: Bank of Japan (<http://www.boj.or.jp>) (December 2002)

²⁵ Translators Note. Revised data as of December 2002

End of Fiscal Year	1997	1998	1999	2000	2001
Combined Net Debt of the Private Non-financial Corporate Sector (Trillion yen)	523	483	587	487	413

Source: Bank of Japan (<http://www.boj.or.jp>) (December 2002)

²⁶ Translators Note. Revised data as of December 2002

End of Fiscal Year	1997	1998	1999	2000	2001
Household Sector Held Net Financial Assets (Trillion yen)	932	944	1,027	1,017	1,011

Source: Bank of Japan (<http://www.boj.or.jp>) (December 2002)

²⁷ Translators Note. Revised data as of December 2002

End of Fiscal Year	1997	1998	1999	2000	2001
Net Overseas Assets (Trillion yen)	128	136	88	135	176

Source: Bank of Japan (<http://www.boj.or.jp>) (December 2002)

so low in Japan, (indeed, they have never been lower at any time in history).

It is true that financial assets held by the central government in the above figures may include some assets, such as loans to special public corporations, which have deteriorated in quality, suggesting the true picture may be somewhat worse than the above figures imply.

However, what is important concerning the balance sheets of central and local governments is not actual net worth but how appropriate the level and direction of spending is, factors which are much more important than the gap between revenue and expenditures.

How imminent is the risk of "crowding-out"?

"Crowding-out," refers to a situation where the government and the private sector vie for real resources such as labor and capital and the government squeezes out the private sector.

The fiscal deficit should always be considered relative to the overall savings-investment balance.

The most critical question as regards government finances is whether an over-grown government will take up resources that could be used more productively by the private sector. Such

"crowding-out" of private demand is the true cause of any possible "burden on future generations".

To establish the extent to which crowding-out may or may not take place, consider the extent of shortfall or excess after the country's total savings is divided between the government

and the private sector. Japan still has large excess savings even after the public and private sectors have shared such savings. Thus, government debt does not currently constitute such a burden.

This is a crucial difference from the situation of the United States of the 1970s and 1980s, or of some of the high-deficit European countries more recently. In both instances, the government's fiscal deficits exceeded domestic private-sector savings; interest rates stayed high and discouraged private investment, always the crucial engine of autonomous growth (especially since in these circumstances, monetary easing is not very effective).

Though it might appear obvious, it is important to spell out just why "crowding-out" constitutes a burden on future generations. In the case of a developed country with a modern, functioning infrastructure, the use of resources by the private sector generally tends to be more efficient than that by the public sector and raises the productive capacity of the economy more²⁸. Should the government embark on greater expenditure than its role demands, the private sector is left with fewer resources, resulting in lower productivity gains and hence lower overall economic growth. Future generations are left with a lower standard of living than they might otherwise have had.

²⁸ Note 7 A study by the EPA, reported in the 1996 White Paper, showed that in Japan the effectiveness of public works expenditures in raising the economy's output potential declined markedly in the latter half of the 1970s. Though the study found that the output-to-capital ratio recovered slightly starting in the mid-1980s, it was still only about a quarter of what it had been in the late 1960s – the era when Japan's "industrial policy" earned its reputation for boosting growth.

Conversely, if public expenditures are productively allocated – be they on infrastructure or environmental protection or whatever- then there is no need to worry about the deficit or "crowding-out." If the public sector uses resources as efficiently as the private sector, the deficit---even when there is one--- is a "good deficit".

This can be compared to the situation of a company that is running an operating deficit at present but investing in promising projects. The capital markets would view the current loss of such a company in light of the prospects for the future and hence the perception would be different to that of a loss incurred by a company with uninspired and conservative management.

What really matters is not the size of the deficit, but how wisely the money is spent.

From the financial perspective, fiscal expenditure will result in higher interest rates and the curtailment of private sector investment. From such a financial angle, it may seem that what is of primary importance is the amount of government's funding, that is, the size of the deficit.

However, this is not the case.

Suppose a "big government" finances its deficit by a tax increase and posts no deficit. In this case there is no tapping of the market for funds by the government, but the increased taxes would cause the savings pool of the private sector to contract, so interest rates might still rise. On the other hand, when there is sizable excess capacity and unemployment - that is, when unutilized savings are large - government funding would likely be amply covered by such excess

savings and would not cause any "crowding-out" especially if monetary policy is not tight.

Even the above-cited Economic White Papers, which tend to stress the negative aspects associated with the fiscal deficits, are sanguine on this point. The 1998 White Paper, for instance, said "at present...the negative impacts arising from crowding-out effects.... do not have to be taken too seriously." The report saw little need for concern unless private demand for funds soars or monetary policy shifts to a tightening bias²⁹.

Might huge deficits cause confidence in government bonds to be shaken? If there were real wide spread fears regarding the Japanese government's ability to repay its obligations, government bond yields would rise but not long-term rates in general.

Generational accounting: Is the deficit a burden on future generations?

Fiscal deficits (i.e. government borrowings) become a burden on the future generation when a bloated public sector reduces the economy's growth potential or when the government deficit is funded by borrowing from abroad.

²⁹ Translator's Note. In the 2000 edition, the EPA staff reported on the work they had done to ascertain the relationship between government financial needs and long-term interest rates, saying in a footnote that there was no statistically significant correlation between the size of the government deficit and long-term rates in countries with current account surplus (i.e., countries with excess domestic savings).

Still, much of the criticism of the LDP's economic policies by the main opposition party, the Democratic Party of Japan, is based on the argument that the government debts was a burden on the future generations, just as a father's debt is a burden on his son. Arguments put forward when the Law to Reform the Fiscal Structure was passed reflected this so-called generational accounting and helped produce the shift in the government fiscal stance in 1997 away from emphasizing support for the economy to the objective of "restoring health in government finances.

This "generational accounting" approach calculates the impact of the government's fiscal measures separately for each age group. Consequently, there is no comparison for the extent of benefits to the middle-aged to old people at the expense of young (or future) generations.

Suppose, for example, tax relief has been introduced now with a promise that taxes will be raised in the future. Present taxpayers, who will be dead by the time of future tax increase, enjoy the benefits while those who become taxpayers when the tax increases take effect are worse off. Is this a case of a burden passed on to future generation? Not really. To understand why, consider two groups: the present generation and the future generation. The only way the present generation leaves a burden on the future generation is if the present generation consumes more than they produce and pays for the difference by borrowing from somebody else. A burden

is left to the future generation when a country as a whole is borrowing from abroad. The future generation then has to limit consumption below the level of production to repay the debt.

Borrowing by a government, on the other hand, so long as it is funded by domestic savings, merely represents a transfer of money among that country's residents.

In order to see this last point more clearly, note that the current account balance measures the difference between a country's production and consumption. Countries with current account deficits are then spending more on goods and services than they are producing, and the difference is added to their external indebtedness. Future generations in such countries must run current account surpluses, by consuming less than they produce to repay the debts.

Of course it is possible for expenditures to fund projects that enhance future production capacity. In this case, the future generation may have net gains even after repaying the debt. The current account deficit then is a "good" one.

The deficit of a government, in contrast, merely represents the difference between government revenue and expenditures. So long as it is funded by domestic savings the above problem does not arise. Those who pay taxes to redeem the debt and those receiving the repayment of principal and interest - that is, bondholders - are both Japanese domestic residents. It is only when a country's current account is already in deficit that government borrowing becomes a burden for future generations. In the case of contemporary Japan, fiscal policy to

stimulate the economy does not alter the size of the current account surplus much.

In the case of government finances, it is not necessary to balance revenue and expenditures. Nor is there a need to reduce the amount of existing government debts to zero.

"Equalizing the tax burden among different age groups" is an important objective, but it does not make the deficit itself a burden, and it does not lead to a conclusion that reducing the deficit should be given top priority.

The greatest danger is not the debt of the government per se but that Japan's long-term growth potential might be impaired by the inappropriate use of resources arising from an inappropriate fiscal policy. There is ample empirical evidence that the business outlook of Japanese companies is strongly influenced by current economic conditions.

Expectations tend to be self-fulfilling because they influence the investment plans of the corporate sector. When many companies become pessimistic, they curtail their investment and the pessimistic forecast is realized. The effect of a policy error can thus be fairly long lasting.

Inequality amongst age groups

There remains, however, the question of inequality in the burdens placed on different generations when a tax cut now is offset by a future tax increase. Unlike the case of the current account deficit countries mentioned earlier, there is no excess of total consumption over output by the

present generation. It is true that future generations have higher tax burdens, but they have also inherited government bonds from the present generation and are receiving principal and interest payments. They do not have to restrain their own consumption in order to repay debts to overseas creditors.

Still, even though these interest payments are only a money transfer within the future generation, the higher general tax level that they require could have consequences, such as depressing incentives and entrepreneurship, or even prompting an exodus of people and companies. That could become a serious burden on future generations but it is a burden arising primarily from big government, not from fiscal deficits.

If the priority is to balance the budget within a certain period, it does make sense to expedite tax increases that may be needed to reduce the future interest payment burden and equalize burdens placed on different age groups. The 1999 Economic White Paper presented estimates showing that the future burden on the present young population would be unbearably heavy if tax increases are not instituted very soon.

This calculation presented by the EPA is very misleading, however. The assumptions used here are 2% for the growth rate of GDP per capita and 4% for real interest rates. However, it is hard to believe that Japan's sluggish economy could provide interest rates of 4% in real terms.

Second, the target year for the EPA's 1999 White Paper exercise is not revealed. If, as

seems likely, the calculation is based on a fixed future point in time, then it is natural that the burden of the present young will grow as the tax increases are delayed. A more natural assumption would be that the target year would also be postponed if the tax increases were delayed. The suspicion arises that the government constructed its calculations with a pessimistic bias, as part of its campaign for "fiscal restructuring".

It might be added that the most often-cited example of inequality among age groups is the obligatory state pension scheme. Those who are presently middle-aged salaried employees joined the scheme years ago, with the understanding that they would be eligible for pensions when they became 55. That age keeps being extended, and many are not sure whether they will ever reach it. On the other hand, there are many older people who have been receiving pensions since they were 55. Indeed, women were initially eligible when they were only 50.

The "generational accounting" approach is useful for addressing these problems. But the basic error concerning the state pension scheme is to have used a drastically wrong population forecast and to have designed a system in which the retired are supported only partly by their past contributions and mainly by the working age groups. As the ratio of those working to those retired keeps declining, the burden on working-age Japanese is becoming unbearable. The solution to this problem cannot be postponed. However, the nature of the problem of overall government finances is very different from that of the state pension scheme.

Qualitative issues: The long-term issues concerning Japan's government finances

To show that the size and allocation of expenditures are much more important than the gap between revenue and expenditures, let us consider what is defined as the "balanced budget multiplier" in economics. Theory states that the effects of simultaneous increases in taxes and government expenditures are stimulative, although the fiscal balance remains unchanged. This is so because the propensity to spend of the private sector is normally smaller than unity, so that a transfer of income to the government, whose propensity to spend is unity in this case, would have a positive effect.

If the biggest problem concerning government finances at present is the size of the deficit, is it proper to raise taxes and increase expenditures at the same time, thereby trying to achieve the twin objectives of stimulating the economy and restoring fiscal balance? The answer to this should be quite obvious. If such policies were repeatedly used, the resultant "big government" would not only use resources inefficiently but also rob the private sector of vigor. There is indeed a long-term risk in Japan that the public sector might become bloated, using resources inefficiently and reducing the growth potential of the economy. If "restoring the health of government finances" is an objective encompassing such concerns, its priority is high. In the long run that hare is running in the same direction as the hare of growth. But fiscal streamlining

in the narrow sense aimed at reducing the deficit, particularly the objective of "reducing the deficit even at the cost of higher taxes", is not the task that should be accorded top priority in Japan of the late 1990s and early 2000s.

This does not preclude the possibility that priorities may shift in the future. Specifically, if the aging of the population reduces aggregate savings and results in the current account balance-of-payments turning into deficit - although this is by no means inevitable - the need to reduce the deficit itself may rise. As things stand now, however, there is a room for Japan's fiscal policy to further contribute to the task of bringing the economy back on to an autonomous and sustained growth path. It should be borne in mind at the same time that if the policy priority is shifted to "restoring fiscal health" in the near future, emphasis should be placed not on reducing the deficit but on reducing the overall size and making the allocation more in line with true needs (as opposed to the needs of those with loud political voice).

4. PROBLEMS ASSOCIATED WITH THE ALLOCATION OF PUBLIC EXPENDITURES

One of the reasons that the active use of fiscal policy has been unpopular among the public - most notably among those living in big cities, as amply demonstrated in recent general elections - is the feeling that money is not flowing where it is truly needed but instead is wasted

on useless projects. It is well known that the allocation of public works has been extremely rigid, with projects well past their usefulness continuing to attract funds. Those involved in the process of budget formulation confess that even a 0.1 percentage change in distribution requires enormous effort.

The process by which actual projects are decided after the budget is passed by the Parliament has also attracted public skepticism. The budget only gives a broad mandate such as "improving roads", while the actual allocation is negotiated behind closed doors among politicians and bureaucrats acting in response to requests from local authorities.

In addition, there are many cases where the central government gives out money to localities to induce them to start projects, without any demonstrable need. Analyses of costs and benefits are often neglected; indeed, in numerous cases, they result in waste and/or damage to the environment. For example, in 1999, "coupons to stimulate localities" were distributed to everyone at or under the age of 15 and to those receiving old age pensions. This can well be called an ultimate "throw-away policy;" reminiscent of Milton Friedman's famous allusion to "throwing away cash from a helicopter"³⁰.

Igarashi and Ogawa have provided a good insight into the process of determination of

³⁰ M. Friedman, "Prescription for Japan: Back to the Future," Asian Wall Street Journal, Dec 18, 1997

the allocation of public works expenditure³¹. They point out that the Parliament only decides on big items. Then, when it comes to deciding on concrete projects, no democratically accountable system is at work.

To come up with better resource allocation is easier said than done, however. Most politicians seem to have given up even trying, unfortunately, in fact all past efforts at reducing the deficit used "the ceiling method:" that is, they set a uniform rate by which most items were cut across the board. Sadly, this method enjoyed wide support from the politicians.

To decide on the allocation of public resources, setting priorities among competing projects, should be one of the basic roles of a politician. To support the "ceiling method", then, is to abdicate this important role. The public is also to blame, however, for demanding that everybody suffer to the same degree when times are hard. A telling episode was reported a few years ago³²:

The heads of the five villages located along one of Japan's coast lines met a Ministry of Finance official, and each wanted a fishing port built in his village. The Ministry official said that five ports would be extremely difficult, but that he could give favorable consideration if the five village heads could agree among themselves on only two ports. The heads replied that they did not want two ports. Either no port at all or all five was their wish. (Eventually all five ports were

³¹ Takayoshi Igarashi and Akio Ogawa, *Kokyo jigyo wo do suru ka?* [What should be done about public works projects?], Iwanami Shoten (1974) ISBN4-00-430492-X C0231

³² *Mainichi Shimbun*, 28th April, 1997

established.)

Not surprisingly, politicians aim to draw public works projects to their constituencies. That of course is hardly unique to Japan. Nor should it be condemned outright in a democracy. Still, two problems stand out as hindering efficient allocation of resources. First, because negotiations are carried out behind closed doors, the outcome tends to reflect the relative power of individual politicians. Second, many public works are carried out either by the central government with its own money or by local authorities with heavy central government subsidies. This means that local authorities rarely foot much of the bill.

Under the present system, a project for which there is no real need can still be drawn to a region simply because it would benefit local construction companies. But, if local authorities were required to foot the bulk of the bill, they would be forced to assign priorities among the competing needs of the region, and could not avoid making "this or that" choices.

The case for more decentralization and the Freedom of Information Act

Decentralization can help to limit wasteful use of resources. Local governments should have to choose "either this or that" If regions have more financial autonomy, they would (in principal) only initiate one project by sacrificing another. This would result in much more thorough and realistic cost-benefit analyses than those undertaken under the current system.

To be sure, some measures to lessen regional inequality in income probably are needed. But this goal can also be achieved by giving poor regions untied subsidies, requiring them to fund their projects from their own purse. The idea that the central government has to control local governments because local governments tend to waste resources is no longer accurate. If decentralization results in an uneven social infrastructure across regions, it should be accepted as the outcome of varying choices made by local residents. There naturally could be some merit in the central government setting a national minimum standard.

The Freedom of Information Act, which was put into effect in 1999, is potentially a strong weapon in improving the implementation of fiscal policy. That public works are allocated through political processes is both natural and inevitable. Up to now, however, there has been little transparency neither in those processes, nor in the ex ante and ex post evaluations. It was never clear who decided what, on what authority.

But if the public asks for information on these points, as they now can, and demands accountability from politicians and bureaucrats, it would be an important first step in improving the decision making on what public works are approved.

Needless to say, the Freedom of Information Act is not a panacea. There have been cases in which some politicians twisted a railway route or made express trains stop at their constituencies. They were widely condemned by the general public but had overwhelming

support from their constituencies. This implies a need to change the framework itself so that the limit of what politicians and bureaucrats can do becomes clearer and choices for them become more in the nature of "either this or that". The aim is not to build a system that can work well if properly run, but to have a system with an institutional check to assure that it won't be run improperly. In any case, while there is a long way to go, the Freedom of Information Act does make it easier for the public to monitor the spending decisions of their elected representatives.

The need for a more effective cap on government finances

This paper has argued that fiscal policy should be actively used as the primary tool to stimulate the economy, a belief based chiefly on economic considerations. (Monetary policy should do its part, too, of course.) At the same time, it is true, given the current realities that it is extremely difficult to trim the size of the government once it has been allowed to grow. Given this legitimate concern, it is worthwhile to consider ways to set an effective cap on government finances.

The Government in fact introduced such a cap in 1997, in the form of the "Law to reform the fiscal structures". That cap was a cap on the deficit rather than the more preferable route of imposing a cap on the size of government expenditures and was, in any case, soon suspended. The ideal solution would be to tie any cap to the state of the economy, say by having

the government commit itself to reduce the size of government expenditure relative to GDP

whenever the expected growth rate of GDP exceeds 2%.

Such a cap would enable the government to use fiscal policy when there is need while simultaneously ensuring that the growth of the public sector does not get out of hand. To insist that a desirable policy cannot be adopted because of political realities is not acceptable.

AUTHOR'S BIO

Kengo Inoue was born in Japan on 14 May 1943. He joined the Bank of Japan in 1967 after graduating from the University of Tokyo. During his years at the BoJ he spent much time in the Research and Statistics Department and had extensive interaction with overseas markets. In early 1970s he completed his Masters in Economics at Oxford University (St. Anthony's College). He was seconded to the Bank for International Settlements from 1977 to 1980 and later on in his career at the BoJ to the Federal Reserve Bank of San Francisco from 1991 to 1992. He was General Manager of the Akita Branch of the BoJ from 1989 to 1991. From 1995 to 1999 he was Advisor to the Governor of the BoJ, Research and Statistics Department. After leaving the BoJ in 1999 he joined Kobe University as Professor in the School of Business Administration. His writings on the Japanese economy have appeared in both Japanese and English in publications such as the *Nihon Keizai Shimbun* and the *Asian Wall Street Journal*. His last major work was a book in Japanese published by the Nihon Keizai Shimbun in June 2000 – *Nani ga tadashii Keizai seisaku ka* [What's right with Japanese economic policy?]. He was diagnosed with cancer in November 2000 to which he succumbed in March 2001.

TRANSLATOR'S FORWARD

Kengo Inoue very much wanted the non-Japanese speaking world to have an insight into the views of Japanese economists and an understanding of the debate taking place within Japan. Well-versed in English, Kengo prepared the first English draft of this paper himself, based on Chapter 2 of his book, *Nani ga tadashii keizai seisaku ka – gendai makuro seisaku ronsou no kenshou* [What's right with Japanese fiscal policy? An examination of the debate on current macro policy], published by the Nihon Keizai Shimbun (June 2000). Following Kengo's untimely death in March 2001, Kengo's wife – Henny Sender and other friend's of Kengo (including myself) were keen to disseminate the English paper that Kengo had been working on. We also felt that despite the passage of time, Kengo's analysis and observations concerning Japanese fiscal policy remain relevant today. The paper retains the integrity of Kengo's own work in English. My work as translator has been to clarify that Kengo's English draft coincided with the original Japanese and that any changes in his English draft were intentional. While amendments to some expressions in Kengo's English draft have been made the content remains the same with the exception of revisions to data. Data has been revised to reflect subsequent events or official revisions as cited in the footnotes. A number of people have contributed to the final work. In particular, my task has been greatly eased by initial editing and review by Masaaki Kanno and Patricia Hagan Kuwayama. I would also like to thank Takeshi Shibasaki of Mizuho Securities for helping to locate much of the updated data. Lastly, I would like to express my thanks for the final editing and overall vision of Henny Sender who, more than anyone, wanted to share this work with non-English speakers so they too could have an insight into the Japanese economy and the views of one particular economist - Kengo Inoue.

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